

**Notice of Proposed Emergency Action and Finding of Emergency**

**The California Department of Tax and Fee Administration**

**Has Adopted California Code of Regulations, Title 18,**

**Section 3702, *California Cannabis Track-and-Trace***

NOTICE IS HEREBY GIVEN that the California Department of Tax and Fee Administration (Department), pursuant to the authority vested in the Department pursuant to Revenue and Taxation Code (RTC) section 34013, has adopted California Code of Regulations, title 18, section (Regulation) 3702, *California Cannabis Track-and-Trace*, as an emergency regulation in accordance with Government Code (GC) section 11346.1, to be codified in chapter 8.7, Cannabis Tax Regulations, in division 2 of title 18 of the California Code of Regulations. Regulation 3702 implements, interprets, and makes specific the following: (1) RTC sections 34010, 34011, and 34015, which apply, as relevant here, to the cannabis excise taxes imposed by part 14.5, Cannabis Taxes, (commencing with section 34010) of division 2 of the RTC, as added by the voters' approval of Proposition 64 (Prop. 64) on November 8, 2016, and amended by Senate Bill No. (SB) 94 (Stats. 2017, ch. 27) and Assembly Bill No. (AB) 133 (Stats. 2017, ch. 253), which is commonly referred to as the Cannabis Tax Law (CTL);<sup>1</sup> and (2) Business and Professions Code (BPC) sections 26067 and 26068, which require the creation of a track and trace program for reporting the movement of cannabis and cannabis products throughout the distribution chain.

**FINDING OF EMERGENCY**

*Section 48 Statement*

GC section 11346.1, subdivision (a)(2), requires that, at least five working days prior to submission of the proposed emergency regulation to the Office of Administrative Law, the Department provide a notice of the proposed emergency action to every person who has filed a request for notice of regulatory action with the Department. After submission of the proposed emergency regulation to the Office of Administrative Law, the Office of Administrative Law shall allow interested persons five calendar days to submit comments on the proposed emergency regulation as set forth in GC section 11349.6.

*Statement of Emergency*

RTC section 34013, subdivisions (a) and (c), require the Department to administer and collect the cannabis excise and cultivation taxes imposed by the CTL and authorize the Department to

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<sup>1</sup> AB 102 (Stats. 2017, ch. 16) established the California Department of Tax and Fee Administration and transferred the State Board of Equalization's (Board's) duties, powers and responsibilities under the RTC to administer and collect the cannabis taxes to the Department, effective July 1, 2017. (GC, §§ 15570, 15570.22). Accordingly, any remaining references to the Board in the CTL or the BPC sections cited herein refer to the Department pursuant to GC section 15570.24 and RTC section 20.5, to the extent that the statutes have not already been amended to reference the Department.

prescribe, adopt, and enforce regulations relating to the administration and enforcement of the cannabis taxes. RTC section 34013, subdivision (e), also authorizes the Department to prescribe, adopt, and enforce any emergency regulations that are necessary to implement, administer, and enforce its duties under the CTL. And, it provides that, for purposes of chapter 3.5 (commencing with section 11340) of part 1 of division 3 of title 2 of the GC, including section 11349.6, the adoption of such a regulation “is an emergency and shall be considered by the Office of Administrative Law as necessary for the immediate preservation of the public peace, health and safety, and general welfare.”

## AUTHORITY

RTC section 34013

## REFERENCE

RTC sections 34010, 34011, and 34015; BPC sections 26067 and 26068.

## INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

### Summary of Existing Laws and Regulations

On November 5, 1996, California voters approved Proposition 215, which added section 11362.5, the Compassionate Use Act of 1996, to the Health and Safety Code (HSC) to exempt certain patients and their primary caregivers from criminal liability under state law for the possession and cultivation of marijuana for medical purposes. In 2003, the Legislature added chapter 2.5, Medical Marijuana Program, (commencing with section 11362.7) to chapter 6 of division 10 of the HSC. (SB 420 (Stats. 2003, ch. 875).) As relevant here, the Medical Marijuana Program statutes defined certain terms, set possession guidelines for medical marijuana, recognized a qualified right to collectively or cooperatively cultivate marijuana for medical purposes, and required the Attorney General to adopt guidelines to ensure the security and non-diversion of marijuana grown for medical use, which the Attorney General released in August of 2008. (HSC, §§ 11362.7, 11362.77, 11362.775, 11362.81.)

In 2015, the Legislature added chapter 3.5 (commencing with section 19300) to division 8 of the BPC, the Medical Marijuana Regulation and Safety Act (MMRSA), through the enactment of a package of three bills (AB 243 (Stats. 2015, ch. 688), AB 266 (Stats. 2015, ch. 689), and SB 643 (Stats. 2015, ch. 719)). As relevant here, the MMRSA established a comprehensive licensing and regulatory framework for the cultivation, manufacturing, transportation, distribution, and sale of medical marijuana and established the Bureau of Medical Marijuana Regulation in the Department of Consumer Affairs to administer the provisions of the MMRSA. Also, as relevant here, the Legislature subsequently changed the name of the MMRSA to the Medical Cannabis Regulation and Safety Act (MCRSA) and changed the name of the Bureau of Medical Marijuana Regulation to the Bureau of Medical Cannabis Regulation, effective June 27, 2016. (SB 837 (Stats. 2016, ch. 32).)

On November 8, 2016, California voters approved Prop. 64, “the Control, Regulate and Tax Adult Use of Marijuana Act (‘the Adult Use of Marijuana Act’)” (AUMA). (Prop. 64, § 1.) As relevant here, the AUMA added division 10, Marijuana, (commencing with section 26000) to the BPC (Division 10) to establish a comprehensive system to control and regulate the cultivation, distribution, transport, storage, manufacturing, processing, and sale of nonmedical marijuana and marijuana products. (Prop. 64, § 6.1.) And, Division 10 required the California Department of Food and Agriculture (CDFA), in consultation with the Bureau of Marijuana Control (previously the Bureau of Medical Marijuana Regulation) and the Department, to establish a track and trace program for reporting the movement of marijuana products throughout the distribution chain that utilizes unique identifiers. (BPC, §§ 26067, 26170, as added by the AUMA.)

The AUMA also added the CTL to the RTC to impose marijuana excise and cultivation taxes, effective January 1, 2018. (Prop. 64, § 7.1.) As relevant here, the CTL, as added by the AUMA, provided that the Department may require every person engaged in the distribution or retail sale of marijuana or marijuana products to file a report using electronic media respecting the person’s inventory, purchases, and sales during the preceding month, and any other information as the Department may require to carry out the purposes of this part, and for reports to be authenticated in a form or pursuant to methods prescribed by the Department. (RTC, § 34015, subd. (b).) And, Division 10, as enacted by the AUMA, expressly required the track and trace program to require the reporting of the amount of cultivation tax due under the CTL. (BPC, § 26170, as added by the AUMA.)

In 2017, the Legislature enacted SB 94 (Stats. 2017, ch. 27).<sup>2</sup> As relevant here, SB 94 repealed the MCRSA, included certain provisions from the MCRSA in Division 10, changed the title of Division 10 to “Cannabis,” changed the name of the Bureau of Marijuana Control to the Bureau of Cannabis Control (BCC), and named Division 10 the “Medicinal and Adult-Use Cannabis Regulation and Safety Act” (MAUCRSA). With respect to taxes, SB 94 amended the CTL to ease and streamline tax collection and remittance to the Department. As relevant here, SB 94: (1) replaced the references to “marijuana” with references to “cannabis” throughout the CTL; (2) revised the cannabis excise tax so that it is imposed upon purchasers at a rate of 15 percent of the average market price, instead of the retail selling price, and is collected by a cannabis retailer, then collected by a distributor from the cannabis retailer and paid to the Department by the distributor, instead of being paid to the Department by the retailer (RTC, § 34011); (3) defined average market price in an arm’s length transaction, to mean the average retail price determined by the wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer, plus a mark-up (RTC, § 34010, subd. (b)(1)); (4) defined arm’s length transaction to mean a sale entered into in good faith and for valuable consideration that reflects the fair market value in the open market between two informed and willing parties, neither under any compulsion to participate in the transaction (RTC, § 34010, subd. (a)); and (5) required the Department to determine the mark-up to be added to the retailer’s wholesale cost of the cannabis or cannabis products sold or transferred to a cannabis retailer for purposes of calculating the average retail price (RTC, § 34010, subd. (b)(1)). The mark-up is to be determined by the Department every six months. As a result, effective January 1, 2018, the CTL imposed a cannabis excise tax upon purchasers of cannabis or cannabis products sold in this state at the rate

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<sup>2</sup> Also in 2017, the Legislature enacted AB 133 (Stats. 2017, ch. 253), which made changes to definitions and requirements under the CTL and the BPC, not specifically relevant here.

of 15 percent of the average market price of any retail sale by a cannabis retailer. (RTC, § 34011, subd. (a).)

As required by Division 10, CDFA has established the California Cannabis Track-and-Trace (CCTT) system for statewide use to record the inventory and movement of cannabis and cannabis products through the commercial cannabis supply chain from cultivation to retail sale and adopted regulations prescribing the information required to be recorded in the system. (Cal. Code Regs., tit. 3, §§ 8402-8407.). All licensees with a state-issued annual cannabis license are required to use the CCTT system to record, track, and maintain information about their cannabis and cannabis product inventories and activities. (Cal. Code Regs., tit. 3, §§ 8402-8407 (CDFA regulations); tit. 16, §§ 5048-5052 (BCC regulations.); tit. 17, § 40100, subd. (kkk), §§ 40510-40517 (California Department of Public Health (CDPH) regulations).)

In addition, the Department has separately adopted Regulation 3700, *Cannabis Excise and Cultivation Taxes*, and Regulation 3701, *Collection and Remittance of the Cannabis Excise Tax*, both as emergency regulations. Regulation 3700 applies to the imposition, collection, reporting and remittance of the cultivation tax and cannabis excise tax, and Regulation 3701 only applies to the imposition, collection, reporting and remittance of the cannabis excise tax.

#### Effect, Objective, and Benefits of Emergency Regulation 3702

With respect to the cannabis excise tax, RTC section 34010, subdivision (b)(1), requires the Department to determine, every six months, a mark-up to be added to the retailer's wholesale cost of cannabis or cannabis products sold or transferred to a cannabis retailer for purposes of calculating the average market price for which the 15 percent cannabis excise tax applies in an arm's length transaction. In general, a mark-up is an amount added to the cost of an item to determine its selling price and a mark-up percentage is the increase in the cost price to arrive at the selling price expressed as a percentage. For example, if an item costs \$100 and it is sold for \$125 the mark-up is \$25 and the mark-up percentage is 25 percent (25/100).

The Department has determined that when determining the required mark-up for purposes of calculating the average market price, the key input variables include the retailer's wholesale cost and retail selling price of cannabis or cannabis products and having actual data regarding the wholesale costs and retail selling prices from the cannabis industry is imperative. Such data will enable the Department to review mark-up percentages from various cannabis or cannabis products, such as flower and manufactured products (e.g., edibles and extracts). The Department also determined that there was an issue because the necessary data is not currently available to the Department and that it is critical for the Department to adopt an emergency regulation to have the effect and accomplish the objective of addressing the issue.

The CCTT system established by CDFA includes an electronic seed to sale software tracking system with data points for different stages of commercial activity, including inventory and sale. All annual licensees are required to utilize the CCTT system. (Cal. Code Regs., tit. 3, §§ 8402-8407; tit. 16, §§ 5048-5052; tit. 17, § 40100, subd. (kkk), §§ 40510-40517.) Because the Department has determined that having retailers' wholesale cost and retail sales prices for cannabis or cannabis products is an essential component of determining the required mark-up,

the Department also determined that utilizing the CCTT system to require licensees to report that data would be more efficient for both the Department and the licensees than requiring licensees to file informational reports. Therefore, the Department worked with CDFA to confirm that the CCTT system can accommodate the input of these amounts. And, the Department prepared a draft of the emergency Regulation 3702 requiring: (1) a distributor with an annual distributor license to record the retailer's wholesale cost in the CCTT system when cannabis or cannabis products are sold or transferred to a retailer; and (2) a retailer with an annual license to record the wholesale cost and retail selling price of cannabis or cannabis products in the CCTT system when sold in a retail sale.

Department staff also prepared and issued a Discussion Paper dated July 20, 2018, regarding draft emergency Regulation 3702, and included a draft of Regulation 3702 as an exhibit. Staff conducted an interested parties meeting on August 2, 2018, to discuss the draft emergency regulation. Staff also accepted written comments regarding the draft emergency regulation and received written comments from multiple interested parties.<sup>3</sup> Multiple interested parties<sup>3</sup> questioned whether it would make more sense to wait until temporary licenses are no longer issued, or until January 1, 2020, before bringing the CCTT system online. The Department considered these comments and notes that the Department does not have the authority to determine when licensees are required to start using or recording information in the CCTT system and does not otherwise determine when the CCTT system will be available. However, the Department has determined that it is necessary to adopt Regulation 3702 at this time so that when licensees are required to utilize the CCTT system, the regulation will be in place to require input of the information the Department has determined is essential to its required determination of the mark-up. The Department also received comments from the Southern California Coalition (SCC) in a letter dated August 13, 2008. SCC stated that the reporting of wholesale costs and retail selling prices is expensive and problematic. SCC also stated that "because the tax is applied before the taxed item is sold," the Department should only require a cannabis retailer to submit information when the retailer "sells something at a discount," so the selling price is less than the amount on which the cannabis excise tax was calculated. The Department considered SCC's comments, notes that distributors and cannabis retailers are already required to record certain information in the CCTT system pursuant to rules and regulations established by the BCC, and has determined that the requirements of Regulation 3702 are necessary for the Department to determine the required mark-up, and the most efficient means to gather the necessary data. The Department has also determined that Regulation 3702 will alleviate the need for the Department to request additional informational reports as authorized under the CTL. (RTC, § 34015, subd. (b).) The Department also received a written comment from the UCBA Trade Association dated August 17, 2018, that explains that changes to the RTC are warranted and the entry of wholesale costs and retail selling prices in the CCTT system will provide valid information to justify future legislative changes.

After discussing the draft emergency regulation with the interested parties and reviewing the interested parties' written comments, the Department made revisions to draft emergency Regulation 3702 that was included with the July 20, 2018, Discussion Paper to have the effect and accomplish the objective of ensuring that the new regulation only requires the recording of

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<sup>3</sup> The parties are John Crenshaw, Dennis Ballere, Julia Ross, Brennan Cameron, Damian Pugliese, Layla Ross, Derek Baer, Nikki Myers, and dgmann and they all separately submitted the same comments.

the essential component amounts necessary to determine the required mark-up. These revisions eliminated the provisions requiring the input of data that is already required by MAUCRSA and clarified that the requirement to input a retailer's wholesale cost in the CCTT system only applies with respect to arm's length transactions. The Department also made revisions to clarify that the regulation's recording requirements only apply to those licensees who are already required to enter information in CCTT system pursuant to MAUCRSA to ensure that the new regulation does not increase the number of distributors and retailers required to record information in the CCTT system. The Department will also continue to work with the interested parties to determine whether there are other issues with the CTL that need to be addressed through the adoption of a regulation, and the Department may amend emergency Regulation 3702.

The Department adopted revised Regulation 3702, as an emergency regulation, because the Department determined that the adoption of Regulation 3702 is necessary to have the effect and accomplish the objective of addressing the critical issue discussed above by requiring distributors and retailers that are already required to record commercial cannabis activity in the CCTT system to also input the wholesale cost and retail selling price of cannabis and cannabis products into the CCTT system.

The Department anticipates that the adoption of emergency Regulation 3702 will promote fairness and benefit distributors, cannabis retailers, and the Department by providing the necessary information for the Department to determine the required mark-up in the most efficient manner for distributors, cannabis retailers, and the Department.

The Department has performed an evaluation of whether emergency Regulation 3702 is inconsistent or incompatible with existing state regulations and determined that the emergency regulation is not inconsistent or incompatible with existing state regulations. This is because Regulations 3700 and 3701 are the only other cannabis cultivation or excise tax regulations and Regulation 3702 is not inconsistent or incompatible with Regulations 3700 and 3701 or the CDFA's, BCC's, and CDPH's reporting regulations cited above. In addition, the Department has determined that there are no comparable federal regulations or statutes to emergency Regulation 3702.

#### DOCUMENTS RELIED UPON

The Department relied on its Discussion Paper regarding proposed emergency Regulation 3702 dated July 20, 2018, the exhibits to the Discussion Paper, and the written comments referred to above in deciding that the adoption of proposed emergency Regulation 3702 is necessary to have the effect and accomplish the objective of addressing the critical issue discussed above by requiring distributors and retailers that are already required to record commercial cannabis activity in the CCTT system to also input the wholesale cost and retail selling price of cannabis and cannabis products into the CCTT system.

#### NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS

The Department has determined that the adoption of proposed emergency Regulation 3702 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the GC.

#### ONE-TIME COST TO THE DEPARTMENT, BUT NO OTHER COST OR SAVINGS TO ANY STATE AGENCY, LOCAL AGENCY, OR SCHOOL DISTRICT

The Department has determined that the adoption of proposed emergency Regulation 3702 will result in an absorbable \$436 one-time cost for the Department to update its website after the emergency rulemaking process is completed (assuming that average hourly compensation costs are \$54.54 per hour and that it will take approximately eight hours). The Department has determined that the adoption of proposed emergency Regulation 3702 will result in no other direct or indirect cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the GC, no other non-discretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State of California.

#### EFFECTIVE PERIOD

RTC section 34013, subdivision (e), provides that the emergency regulations adopted by the Department may remain in effect for two years from adoption. Therefore, Regulation 3702 shall be effective immediately upon filing with the Secretary of State and shall remain in effect for two years from that date, unless the Department amends or repeals it before the expiration of the two-year period.

#### CONTACT PERSONS

Questions regarding the substance of Regulation 3702 should be directed to Monica Gonzalez Silva, Tax Counsel IV, by telephone at (916) 323-3138, by e-mail at [Monica.Silva@cdtfa.ca.gov](mailto:Monica.Silva@cdtfa.ca.gov), or by mail at California Department of Tax and Fee Administration, Attn: Monica Gonzalez Silva, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Other inquiries concerning the emergency regulation should be directed to Robert Wilke, Program Policy Specialist, by telephone at 916-445-2137 or by email at [BTfD-BTC.InformationRequests@cdtfa.ca.gov](mailto:BTfD-BTC.InformationRequests@cdtfa.ca.gov). Mr. Wilke is the designated backup contact person to Ms. Silva.

#### TEXT OF EMERGENCY REGULATION 3702

(A new regulation to be added to Cal. Code Regs., tit. 18, div. 2)

#### **Regulation 3702. California Cannabis Track-and-Trace.**

A distributor or cannabis retailer that is required to record commercial cannabis activity in the California Cannabis Track-and-Trace system pursuant to the Medicinal and Adult-Use Cannabis Regulation and Safety Act (commencing with section 26000 of the Business and Professions

Code), shall enter into the California Cannabis Track-and-Trace system specified information as follows:

(1) Wholesale Cost. When cannabis or cannabis products are sold or transferred to a cannabis retailer in an arm's length transaction, the distributor and cannabis retailer shall enter the cannabis retailer's wholesale cost of the cannabis or cannabis products.

(2) Retail Selling Price. When cannabis or cannabis products are sold in a retail sale, the cannabis retailer shall enter the retail selling price of the cannabis or cannabis products.

Note: Authority cited: Section 34013, Revenue and Taxation Code. Reference: Sections 34010, 34011 and 34015, Revenue and Taxation Code; Sections 26067 and 26068, Business and Professions Code.